Considerations to Help Assure Farm Partnership Continuation

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A farm business partnership is a joint business effort by two or more people for profit. The majority of the partnership agreements are not in writing and even many of those in writing do not include provisions for continuation in case of a dissatisfied partner or the death of a partner.

Partnership continuation upon the withdrawal of a partner can be assured by providing for either the purchase by the remaining partner of a withdrawing partner's interest; continuity in the event of a partner's death, by providing for the purchase by the remaining partner of the deceased partner's interest or by making the decedent's estate a partner for a definite term.

Continued existence of the business, despite death or withdrawal of a participant, is one of the major advantages secured by doing business in corporate form. However, by the use of appropriate provisions in the articles of partnership, you may obtain substantially the same continuity for a partnership.

When there is no written partnership agreement, any partner can dissolve the partnership and the death of a partner automatically ends the partnership. The withdrawing partner or estate of the deceased partner becomes a creditor of the partnership and can force a settlement.

Your lawyer is a key resource person in helping with written provisions in your partnership agreement to assure continuation of the business upon death or voluntary withdrawal of a partner.

The provisions for continuation should insure that the withdrawal of a partners interest does not severely impair the ability of the business to continue. Payments may be made with interest on the principal amount due or if agreeable by all parties, a share of the profits until full payment has been made. There are several basic patterns that should be considered as follows:

A. Purchase on Voluntary Withdrawal[1/] - Generally, the partnership agreement should provide the remaining partners with an option (not a binding agreement) to purchase the interest of a voluntarily withdrawing partner at a stated price or pursuant to a specified formula. If there are provisions against withdrawal prior to the expiration of a specified term, penalties may be provided for their breach; for example, the option to purchase may be cast in terms favorable to the remaining partners. A common provision is to establish an option price or a formula for fixing the option price and further provide that the remaining partners may make payment partly in cash and the balance in installments over a term of years, with interest fixed at a moderate rate. The method of determining the purchase price will be discussed below. The provision should be clearly stated as an option on the part of the nonwithdrawing partners and not a binding agreement. A modification of this provision would be to pay off the withdrawing partner by paying him his share of profits for a limited period. Provision should be made to allow the active partners some compensation for services, to be treated as expense before computation of distributable profits.

Although a member of a partnership always has the power to withdraw from the firm, the economic sanctions imposed for withdrawal in contravention of the articles of agreement protect the remaining partners.

B. Transfer of Interest on Withdrawal[1/] - The partners may agree to adopt a corporate concept to effect continuity of the business. The articles may provide that any one or more partners may sell or assign his partnership interest, with or without the consent of the other partners. There are several variations that this provision may take. The right to sell or assign may (but usually would not) be absolute and unqualified. This would constitute a purely corporate approach to the attribute of free transferability.

A more customary provision would permit a sale of the partnership interest, subject to restrictions upon the purchaser's rights of management and control. Another variation is to permit the sale upon condition that a Limited Partnership would be formed with the purchaser becoming a limited and not a general partner.

C. Providing for Termination by Death[1/] - Death of a partner is the most common cause of termination of partnerships. Unless provision is made in the articles of agreement, death means dissolution and liquidation.

Continuation of the enterprise can be effected by giving the surviving partners the right to continue the business either by purchasing the deceased partner's interest or by making the decedent's estate a partner for a definite term.

Provisions for purchase of a decedent's share may be an option or absolute obligation. An obligation to purchase may become burdensome if the business has become unprofitable or impractical to operate without the deceased as a partner. An option to purchase gives greater flexibility and ordinarily is the more desirable solution. However, the partners may prefer an absolute buy-and-sell agreement as protection for their estates. Absolute purchase obligations will frequently be funded with life insurance.

Whether or not an option or firm agreement to purchase is provided, the problems exist of fixing the value of the interest and arranging a method of payment. Some conflict of interest is inherent in the solution. Quite naturally the survivors will want to keep the purchase price as low as possible and to pay the agreed price in installments over a protracted period. The decedent, on the other hand, will prefer to have his estate receive the maximum amount with a minimum of delay.

Although the value of the deceased partner's interest is ordinarily determined as of the date of death, the method of arriving at the purchase price must be fixed in advance in the agreement. Book value, valuation by appraisers, periodical valuation by the partners, or capitalization of earnings are all methods for determining the purchase price.

Once the purchase price is established by either a fixed amount or a formula, the problem of payment must still be solved. The instances are rare in which the remaining partners have the resources to pay a substantial sum in cash. One solution is to pay installments over a term of years. This, however, has certain disadvantages to the deceased partner's estate. Unless the partnership has real estate that can be mortgaged to secure payment of the future installments, there is a risk of nonpayment. Furthermore, distribution of the estate of the deceased partner may be delayed until the final installment is paid. On the other hand, the remaining partners are burdened by the installments of principal that are not deductible in determining the partners' income taxes.

The most practical solution for both the deceased and the surviving partners may be life insurance, as this will provide a definite sum with which to purchase the deceased partner's interest at the required time. For the estate of the decedent, it provides immediate payment in cash.

To arrange a life insurance program, several choices may be considered. First, the premiums may be paid by each partner on the insurance on his own life or on the life of the other partners. Or the partnership itself may pay the premium. In either case, for income tax purposes, the premiums will not be deductible because they are not ordinary and necessary business expenses. Moreover, the surviving partners are direct or indirect beneficiaries under the policies.

The beneficiary may be the partnership, the other partners, or the estate or a relative of the deceased partner. For federal estate tax purposes, insurance on a deceased partner's life is taxable if the proceeds are payable to his estate or if the decedent possessed any of the incidents of ownership. Therefore, the insurance to cover the purchase price of the deceased partner's interest should be payable to the surviving partners, the partnership, or a trustee. The application for each policy should be made by one partner on the life of the other, and ownership retained by the applicant, who is also named beneficiary. This is known as the cross purchase plan. If there are several partners, the partnership itself may apply for the insurance, own the policies, and pay the premiums. This is known as the entity purchase plan. Either method will prevent inclusion of both the insurance and the partnership interest in the deceased partner's estate. The partnership agreement should provide that the proceeds of the insurance shall be used for the purchase of the deceased partner's interest.

It is advisable to make the insurance payable to a trustee rather than to the surviving partner or partners individually. Such payment will assure against unforeseen contingencies that could prevent the surviving partners from carrying out the obligation to use the proceeds for the purchase of the deceased partner's interest. There is a distinct income tax disadvantage in providing that the insurance shall be paid directly to the estate of the deceased partner or to his widow or children. In such instance, there is no increase in the cost basis of the surviving partners' capital interests, despite the fact that they have acquired the decedent's interest, and there would be taxable gain on a later sale.

The income tax consequences of any arrangement to continue the business by purchasing the decedent's interest should not be overlooked. Payments made by the partnership in exchange for the interest of the deceased partner in partnership property are treated as a purchase by the remaining partners, and no deduction is allowed to the partnership. In such a situation, the survivors pay income tax on all partnership income earned after the death of the deceased partner, although the arrangement for such payments may be made in terms of installment payments over a term of years. The estate of the deceased partner has capital gain only as far as cash payments exceed its basis for the partnership interest. To the extent that partnership property includes inventory items that have substantially appreciated in value, the estate will have a stepped-up fair-market value basis and will realize, usually, no ordinary income. Payments by the partnership attributable to the interest of the decedent in partnership property consisting of unrealized receivables are treated as a distributive share of partnership income, or a guaranteed payment by the partnership, and are taxable to the decedent's estate as income of the decedent. Payments for the decedent's interest in the goodwill of the partnership are similarly treated unless the partnership agreement provides for a payment with respect to such goodwill, in which event it will be treated as a capital item. Thus the partnership agreement can largely determine whether the deceased partner's estate or the surviving partners will be taxable on amounts paid by the partnership in excess of the value of the decedent's interest in specific partnership assets - amounts attributable to the reasonable value of the partner's interest in goodwill. Goodwill payments by the surviving partners individually, however, will not be treated as ordinary income to the estate.

If the surviving partner does not wish to give the decedent's estate or heirs a voice in management or control, the agreement can provide for the continuation of the business as a limited partnership with the surviving partner or partners acting as general partners and the deceased partner, his estate, or heirs as limited partners. This arrangement has the added advantage of limiting the liability of the deceased partner's estate or successors in interest.

The surviving partners may wish to defer their decision whether to continue the partnership with the estate of the deceased partner substituted as a general or limited partner. The partnership agreement may provide that the deceased partner's interest shall be appraised and left in the partnership as a loan with a share of the profits to be paid to the estate in lieu of interest. In this way the estate becomes a creditor for an agreed period with no general liability for future partnership debts. At the end of the specified term, the partners can either liquidate the debt or, with the agreement of the deceased partner's estate or the beneficiaries, continue the business with the latter as a general or limited partner.

There are tax advantages to the surviving partners to provide for liquidation of the retiring or deceased partner's interest through payment of his share of future profits rather than the purchase of his interest outright. The surviving partners can deduct from partnership earnings payments to the retiring partner, the estate of the deceased partner, or his beneficiaries, which payments represent a share of profits in lieu of interest on a loan or otherwise. All payments based on a percentage of profits or those not in payment of the deceased or retiring partner's interest in partnership property are deductible to the remaining or surviving partners. In any event, the payments that the retiring partner, the estate of the deceased partner, or the deceased partner's beneficiaries receive will be subject to income tax either as a share of partnership income or as interest income. If payments are made by the partnership partly in payment of an interest in the partnership and partly as a distributive share of income or a guaranteed payment, taxable as income, without being specifically so designated, the regulations provide for an apportionment for each installment.

The commuted value of payments to be made by the surviving partners to the estate of a deceased partner for his capital interest is includible in the gross estate of the deceased partner for federal estate tax, even though the payments made may be from partnership income accruing after death. Furthermore, the commuted value of payments that are income to the estate of the deceased partner as a share of distributable profits are also included in the gross estate of the decedent for purposes of the federal estate tax. In such case the income is also taxable to the recipient as "income in respect of a decedent." The federal estate tax paid on such income is allowed as a deduction for income tax purposes.

There are, therefore, conflicting tax interests among the continuing partners, the retiring or withdrawing partner, and the deceased partner's estate. The last has an interest in having the payments considered as being made for the sale of his interest, while the remaining partners would prefer to regard them as made in liquidation of that interest. Careful tax planning, however, can avoid conflict and serve the interests of both parties.

To summarize, a partnership can provide a measure of limited liability and actual continuity of the business, despite the death or withdrawal of a partner. Thus, through the use of proper agreements, a partnership can actually partake of two of the most advantageous attributes of a corporation without the formality of incorporation.

1/ Sobeloff, Jonathan, Taxation/Practice Handbook #7,]974, pg. 36-44
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